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# Where Does the *Dirham* Stop in a *Sukuk* Default?

By IRINA MARINESCU\*

## I. Introduction

There were at least eighty-eight global protests during the week of February 14, 2011.<sup>1</sup> The most prominent were in the Arab world (e.g., Egypt, Bahrain, Yemen, Morocco, Libya).<sup>2</sup> Some argue these protests are owed at least in part to global economic uncertainty and instability, even going so far as to blame Ben Bernanke.<sup>3</sup> Still others suggest Islam has been a deterrent to economic growth in the Arab world.<sup>4</sup> Although the latter claims are broad and thus hard to

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1. *World On Fire - Mapping Last Week's 88 Global Protests*, ZERO HEDGE (Feb. 18, 2011), <http://www.zerohedge.com/article/world-fire-mapping-last-weeks-88-global-protests>. See also *The Path of Protest*, THE GUARDIAN (Jan. 5, 2012), <http://www.guardian.co.uk/world/interactive/2011/mar/22/middle-east-protest-interactive-timeline>.

2. *Political Unrest in North Africa and the Middle East*, N.Y. TIMES (Feb. 21, 2011), <http://www.nytimes.com/interactive/2011/02/21/world/middleeast/update-mideast-countries.html?ref=middleeast>.

3. *Is Bernanke To Blame For The Rising Global Revolutionary Wave?*, ZERO HEDGE (Feb. 19, 2011), <http://www.zerohedge.com/article/bernanke-blame-rising-global-revolutionary-wave>.

4. See John Cassidy, *Annals of Economics: Prophet Motive*, THE NEW YORKER (Feb. 28, 2011), [http://www.newyorker.com/reporting/2011/02/28/110228fa\\_fact\\_cassidy](http://www.newyorker.com/reporting/2011/02/28/110228fa_fact_cassidy) (introducing arguments by Harvard's David Landes, Princeton's Bernard Lewis, Max Weber, and Timur Kuran to the effect that religion generally plays a

substantiate empirically, is the underlying conceptual connection between economic and sociopolitical instability far-fetched?<sup>5</sup> This is not to say that economic uncertainty is alone to blame. Underlying economic uncertainty are the rules (read: laws) governing the Arab world and the West. This Note focuses on the rules governing Islamic finance. More specifically, this Note posits that one complicating factor to growth in the *sukuk* space is the lack of legal clarity around default mechanisms.<sup>6</sup>

Even if the conceptual connection between economic and sociopolitical instability on the one hand, and legal clarity in finance on the other – seems tenuous or simplistic,<sup>7</sup> there are other

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central role in economic development (Weber), and that Islam specifically long-eschewed the scientific and intellectual activity underlying economic development (Landes and others)).

5. Recall the Great Depression. See LIAQUAT AHAMED, *LORDS OF FINANCE: THE BANKERS WHO BROKE THE WORLD* (2009) (account of the Great Depression as told through the interactions among the four most powerful players at the time: Benjamin Strong of the Federal Reserve of New York, Montagu Norman of the Bank of England, Emile Morceau of the Banque de France, and Hjalmer Schacht of the Reichsbank of Germany. The liquidity crisis of 1914 bears relevance to the 2008 credit crunch and ensuing global debacle.). Also consider Bahrain's sovereign *sukuk* issue, which has attracted widespread international attention from both Islamic and conventional bankers. See Rodney Wilson, *Overview of the Sukuk Market*, in *ISLAMIC BONDS: YOUR GUIDE TO ISSUING, STRUCTURING AND INVESTING IN SUKUK 4* (Euromoney Institutional Investor PLC 2004). Bahrain was during the Arab Spring considered by some to be the epicenter of current sociopolitical instability. See *Taking Back Bahrain's 'Tahrir'*, AL JAZEERA (Feb. 19, 2011), <http://english.aljazeera.net/indepth/2011/02/2011219201753524228.html>.

6. Specifically, this Note focuses on *sukuk*-specific considerations. *Sukuk* are participatory certificates frequently conceived of as Islamic bonds. See Dr. Asyraf Wajdi Dusuki & Shabnam Mokhtar, *Critical Appraisal of Shari'ah Issues on Ownership in Asset-Based Sukuk as Implemented in the Islamic Debt Market*, INT'L SHARI'AH RESEARCH ACADEMY FOR ISLAMIC FIN. (2010), available at <http://uaelaws.files.wordpress.com/2012/03/critical-appraisal-of-shariah-issues-on-ownership-in-asset-based-sukuk-as-implemented-in-the-islamic-debt-market.pdf>; Solomon Teague, *Awaiting Sukuk Clarity*, INT'L FIN. REV. (2010), <http://www.ifre.com/awaiting-sukuk-clarity/610385.article> (introducing many of the same considerations – legal and otherwise – addressed herein).

7. See *Young Anti-Government Protesters Gather In Yemen*, N.P.R. MORNING ED. (Feb. 21, 2011), <http://www.npr.org/2011/02/21/133932016/Yemen-Protests-Update> (describing protesters as educated yet unemployed twenty-somethings); *Arabian Gulf sukuk shunned by Asia on unrest*, ARABIAN BUSINESS (Feb. 21, 2011), [http://www.arabianbusiness.com/arabian-gulf-sukuk-shunned-by-asia-on-unrest382091.html?utm\\_source=twitterfeed&utm\\_medium=twitter](http://www.arabianbusiness.com/arabian-gulf-sukuk-shunned-by-asia-on-unrest382091.html?utm_source=twitterfeed&utm_medium=twitter) (reporting investor avoidance of "[Shari'ah]-compliant debt in the Middle East as unrest escalates across the region, causing concern that economic growth and investment will slow."). This is to say that the economic growth predictions are bleak, suggesting a vicious cycle of sociopolitical and economic unrest.

compelling reasons for why attention to the legal resolution of *sukuk* defaults is warranted. One reason is strong global demand for *sukuk*.<sup>8</sup> This demand continues to grow in the wake of the recent global credit crunch and ensuing liquidity crisis.<sup>9</sup> Moreover, demand is widespread across different forms of issuers (i.e., sovereign as well as corporate).<sup>10</sup> However, "until a *sukuk* default is satisfactorily settled, uncertainty will cloud the market."<sup>11</sup>

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8. See Neeta Thakur, *Safe as Houses? Sukuk on the Rise*, GULF BUSINESS (Dec. 30, 2011), available at <http://www.highbeam.com/doc/1G1-276201938.html> ("Sukuk market exits 2011 in a jolly mood. Funds raised through Sukuk will rise three-fold this year, to heights last enjoyed before the financial crisis."); 'Time is ripe' for Islamic finance, INFRASTRUCTURE INVESTOR (Oct. 31, 2011), <http://www.infrastructureinvestor.com/Article.aspx?article=63991>; *How to set sukuk free*, INT'L FIN. L. REV. (Dec. 2007), <http://www.iflr.com/Article/1976852/How-to-set-sukuk-free.html> ("Demand for *sukuk* has been strong in recent years. The boom in oil prices has delivered a cash windfall for Middle Eastern investors at a time when they are becoming more meticulous in applying religious principles to their investments. Since its birth in 2002, the *sukuk* market has grown remarkably. Standard & Poor's recently estimated that the global market is worth over \$80 billion . . . The *sukuk* market is expected to continue to grow, as more businesses seek to tap the liquid petrodollars and the demand for [S]haria-compliant product."). See also *Introduction to Islamic project finance*, CLIFFORD CHANCE (Jan. 2009), [http://www.cliffordchance.com/publicationviews/publications/2009/01/introduction\\_to\\_islamicprojectfinance0.html](http://www.cliffordchance.com/publicationviews/publications/2009/01/introduction_to_islamicprojectfinance0.html) ("A key cornerstone of the Islamic finance industry has been the development and growth of the *sukuk* market a market which now has global reach and appeal to both Muslim and non-Muslim investors.").

9. *Sukuk market set to rebound says report*, GULFBASE, (Jan. 18, 2011) <http://www.gulfbase.com/site/interface/NewsArchiveDetails.aspx?n=164491> ("The value of *sukuk* has jumped 61[%] in the past year, according to a research [report] by Trowers & Hamlin, the international law firm. A total of \$7 billion of *sukuk* were issued in the year to June 2010 compared to \$4.3 billion the previous year.").

10. Jack Bunker, *The Crucible of Islamic Finance: Dissolving IIG's \$200[MM] Sukuk*, WESTLAW BUSINESS CURRENTS (July 25, 2010), <http://currents.Westlawbusiness.com/Article.aspx?id=a8736b6e-24be-4049-bb7a-a33559d5893c> (discussing a *sukuk* default by Kuwait's International Investment Group, a state-owned Shari'ah-compliant investment company).

11. Robin Wigglesworth, *Fears rise over Islamic bonds*, FIN. TIMES (Nov. 27, 2009), <http://www.ft.com/cms/s/0/7e73fb0a-dac5-11de-933d-00144feabdc0,s01=1.html#axzz1Fgw5N27t>. See also Muhammad Al-Bashir Muhammad Al-Amine, *Sukuk Market: Innovations and Challenges*, ISLAMIC ECON. STUD. Vol. 15, No. 2, at 18 (Jan. 2008), available at [http://www.irti.org/irj/go/km/docs/documents/IDBDevelopments/Internet/English/IRTI/CM/downloads/IES\\_Articles/Vol15-2..MBashirAlamin--SukukMarket.Innovation.pdf](http://www.irti.org/irj/go/km/docs/documents/IDBDevelopments/Internet/English/IRTI/CM/downloads/IES_Articles/Vol15-2..MBashirAlamin--SukukMarket.Innovation.pdf) ("A properly functioning financial market depends on the enforceability of the contracts concerned. Markets may thrive on economic uncertainty, but not under legal ambiguity."). But see Yavar Moini, *Comparisons and differences between sukuk and conventional products*, in SUKUK AND ISLAMIC CAPITAL MARKETS: A PRACTICAL GUIDE 47 (Rahail Ali ed., 2011) (suggesting

Uncertainty in the market can make it difficult for creditors or lenders to assess risk, precluding wider participation and increasing transaction or borrowing costs. For instance, it is conceivable that a *Shari'ah*-compliant sovereign wealth fund reliant on *sukuk* capital markets might experience difficulty in meeting capital commitments.<sup>12</sup> This might result in widespread uncertainty around how to price related risk. It is thus in the global best interest to clarify *sukuk* default mechanisms.

Finally, clarity is in investors' best interest. According to Mohammed Khnifer, a prolific journalist specializing in Islamic finance, originators previously "spent a lot of time on the matter of credit enhancements (protecting banks) and very little time on protecting investors' rights."<sup>13</sup> Given this Note's focus on how to tightly structure secure investments and thereby foster sustainable economic growth (and pave the way for socioeconomic stability), thinking through *sukuk* default repercussions provides a promising start.

## II. Introduction to Islamic Finance and *Sukuk*

### A. The Building Blocks

Islamic finance is rapidly evolving.<sup>14</sup> According to Sheikh Muhammad Taqi Usmani, a cleric and one of the world's leading scholars of Islamic finance,<sup>15</sup> "the basic difference between [a] capitalist and Islamic economy is that in secular capitalism, the

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*Shari'ah*-compliant credit default swaps as an effective way to mitigate default risk).

12. This scenario might warrant attention especially since sovereign Gulf-based wealth funds were responsible for rescuing many financial institutions at the height of the credit crunch. *Sovereign Wealth Funds: Dishdashing to the Rescue*, THE ECONOMIST (Nov. 29, 2008), <http://www.economist.com/node/10229471>.

13. Mohammed Khnifer, *Lex Islamicus: When Sukuk Default Asset Priority of Certificate-holders vis a vis Creditors*, OPALESQUE (Sept. 2, 2010), [http://www.opalesque.com/OIFI181/Lex\\_Islamicus\\_Sukuk\\_Default\\_Asset\\_Priority81.html](http://www.opalesque.com/OIFI181/Lex_Islamicus_Sukuk_Default_Asset_Priority81.html).

14. Ehsun A. Zaidi, *Overview of Islamic Capital Markets*, in ISLAMIC FINANCE: A PRACTICAL GUIDE 95 (outlining the growth of Islamic capital markets and the *sukuk* product specifically). See also *Islamic Finance Market Turns to Securitization*, INT'L FIN. L. REV. (July 2005) (outlining the market's evolution from humble beginnings); *How to set sukuk free*, *supra* note 8 (forecasting continued growth in the *sukuk* space).

15. See *Sri Lanka to launch first Islamic bank*, NEW HORIZON: GLOBAL PERSPECTIVE ON ISLAMIC BANKING & INSURANCE 6 (July - Sept. 2009), No. 172, available at [http://www.islamic-banking.com/resources/7/NewHorizonPreviousIssues/NewHorizon\\_JulySep09.pdf](http://www.islamic-banking.com/resources/7/NewHorizonPreviousIssues/NewHorizon_JulySep09.pdf) (introducing Justice Taqi Usmani as a prominent scholar).

profit motive or private ownership are given unbridled power” whereas in Islam they are restrained by divine injunctions.<sup>16</sup>

The cardinal injunction is a prohibition against *riba* (interest), which means that *Shari’ah*-compliant investments cannot be structured as traditional debts for borrowed money.<sup>17</sup> Why? According to a prominent jurist, when

the whole economy turns into a debt-oriented economy. . . [it] not only dominates over the real economic activities and disturbs its natural functions by creating frequent shocks, but also puts the whole mankind under the slavery of debt.<sup>18</sup>

Interest really means a predetermined return on money, rather than a return that reflects exposure to the commercial activity for which the financing is provided.<sup>19</sup> Islamic financial philosophy favors trade and the sharing of commercial risk, so it does not sanction predetermined return without acceptance of commercial risk by the financier.<sup>20</sup> As a result, Islamic financing institutions have developed sophisticated interest-free banking transactions based on concepts of partnership and profit-loss sharing.<sup>21</sup>

Second, *Shari’ah* prohibits *gharar*, which is an “unacceptable” level of risk or uncertainty, so any *Shari’ah* financing transaction must not be deemed speculative or otherwise uncertain.<sup>22</sup> Thus, a sale contract where the existence, price, quantity or material characteristics of the asset are unknown or unspecified would not be recognized under *Shari’ah*.<sup>23</sup>

One kind of uncertainty is that in outcome, and *Shari’ah*

16. Muhammad Taqi Usmani, *AN INTRODUCTION TO ISLAMIC FINANCE* xiv (2002).

17. *Islamic Finance in the United States*, LATHAM & WATKINS, LLP 1 (May 19, 2008), [http://www.lw.com/upload/pubContent/\\_pdf/pub2191\\_1.pdf](http://www.lw.com/upload/pubContent/_pdf/pub2191_1.pdf).

18. Rafe Haneef, *Recent Trends and Innovations in Islamic Debt Securities: Prospects for Islamic Profit and Loss Sharing Securities*, in *ISLAMIC FINANCE: CURRENT LEGAL AND REGULATORY ISSUES* 29 (S. Nazim Ali ed., 2005), available at [http://www.rdis.ir/RDFiles/IslamicFin/Recent\\_Trends\\_and\\_Innovations\\_in\\_Islamic\\_Debt\\_Securities44.pdf](http://www.rdis.ir/RDFiles/IslamicFin/Recent_Trends_and_Innovations_in_Islamic_Debt_Securities44.pdf) (citing MUHAMMAD TAQI USMANI, *THE HISTORIC JUDGMENT ON INTEREST DELIVERED IN THE SUPREME COURT OF PAKISTAN* 36-37, 87 (Idaratul Maarif ed., 2000)).

19. Anzal Mohammed & Hooman Sabeti-Rahmati, *Understanding Islamic Finance*, ALLEN & OVERY, LLP (May 23, 2008), <http://www.allenoverly.com/AOWEB/Knowledge/Editorial.aspx?contentTypeID=1&itemID=34362&prefLangID=410>.

20. *Id.*

21. LATHAM & WATKINS, *supra* note 17, at 1.

22. *Id.*

23. Mohamed & Sabeti-Rahmati, *supra* note 19.

accordingly forbids gambling or speculation.<sup>24</sup> Consequently, conventional insurance, futures, and options contracts are prohibited.<sup>25</sup> The result is that hedging risk with Islamic securities can be more of a challenge than in conventional finance. Finally, a *Shari'ah*-compliant transaction must not involve investments that are *haram* or prohibited in Islam,<sup>26</sup> such as investments in gambling operations, alcohol, or pork products.<sup>27</sup>

Put differently, Islamic finance prizes risk sharing in furtherance of social and economic welfare.<sup>28</sup> This philosophy considers the predetermined and fixed interest rate to be exploitative on the borrower and instead favors a profit and loss sharing arrangement between creditor and debtor.<sup>29</sup> As a result, Islamic debt capital markets<sup>30</sup> have evolved that bear certain structural relevance to Western bond markets despite the *Shari'ah* prohibition on interest-bearing debt instruments.<sup>31</sup>

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24. *Id.*

25. *Id.*

26. See Michael J.T. McMillen, *25th Anniversary Symposium Issue: Article: Asset Securitization Sukuk and Islamic Capital Markets: Structural Issues in These Formative Years*, 25 WIS. INT'L L.J. 703, 740 (2008) (outlining eligible asset classes).

27. LATHAM & WATKINS, *supra* note 17, at 1.

28. Ali Adnan Ibrahim, *Financial Innovations in the Muslim World: The Rise of Customary Businesses in International Financial Markets: An Introduction to Islamic Finance and the Challenges of International Integration*, 23 AM. U. INT'L L. REV. 661, 664 (2008).

29. *Id.*

30. Note that this Note looks primarily to the Gulf *sukuk* market, which is distinct from the Malaysian market. See Sukuk: *Pushing innovation*, INT'L FIN. L. REV. (Mar. 2009), <http://www.iflr.com/Article/2117392/Sukuk-Pushing-innovation.html> (discussing the Malaysian market); *Islamic Finance Market Turns to Securitization*, *supra* note 14 (discussing variance across the more developed Malaysian *sukuk* market vis-à-vis the less homogeneous Middle Eastern *sukuk* market). Note also that some literature is inaccessible to non-Arabic speakers, thus limiting the authority of this Note. See Al-Amine, *supra* note 11, at 16–17 (discussing difficulties to harmonization efforts across the GCC and Malaysian markets, adding that “the efforts by the two Academies have also their shortcomings. For example, each of the two Academies is meeting only once a year; they are not focusing on Islamic finance issues only and the involvement of Muslim economists seems to be limited. Moreover, the papers and the discussions are not accessible to English speaking practitioners as they are documented in Arabic and the two institutions are lacking adequate resources for employing full-time professional staff well versed in both the *Shari'ah* and finance.”).

31. Ibrahim, *supra* note 28, at 708 (“Islamic law prohibits interest-bearing debt instruments. However, some Islamic-law-compliant transactions do involve debt . . .”).

## B. The Buildings

The most prominent Islamic financial structures are: *mudaraba* (profit-sharing), *musharaka* (partnership financing), *murabaha* (mark-up financing), *ijara* (leasing), *istisna'a* (pre-production financing),<sup>32</sup> and *sukuk* (Islamic bonds). This Note focuses on the latter.

A *sukuk* is essentially a fixed income security that functions like a conventional bond but is structured in a *Shari'ah*-compliant manner such that it resembles a trust certificate.<sup>33</sup> Due to the *Sharia'ah* prohibition on traditional interest-bearing debt,<sup>34</sup> *sukuk* are not categorized as debt but rather represent a profit and risk sharing partnership between the issuer and the investor.<sup>35</sup>

The unique feature of a *sukuk*, as compared to a conventional bond or a conventional structured note, is that the issuer of the *sukuk* is also the trustee, but the issuer has no obligation independent of the *sukuk* assets to pay because the *sukuk* is not an IOU. . . .<sup>36</sup>

The basic framework underlying *sukuk* consists of a special purpose vehicle (SPV) or distinct legal entity that issues *sukuk*<sup>37</sup> (or

32. Nathan Piper, *Assessing the Potential for Shari'ah-Compliant Project Finance in India*, 47 COLUM. J. TRANSNAT'L L. 418, 426 (2009).

33. LATHAM & WATKINS, *supra* note 17, at 6. See also *Islamic Finance Market Turns to Securitization*, *supra* note 14 ("Sukuk is frequently referred to as an Islamic bond, but a more accurate translation of the Arabic word would be an Islamic investment certificate. The distinction being that, at its simplest, a bond is a contractual debt obligation whereby the issuer is contractually obliged to pay to bondholders, on certain specified dates, interest and principal. In comparison, under a *sukuk* structure the *sukuk*-holders each hold an undivided beneficial ownership interest in the underlying assets. Consequently, *sukuk*-holders are entitled to share in the revenues generated by the *sukuk* assets as well as being entitled to share in the proceeds of the realization of the *sukuk* assets. The legal structure and form of *sukuk* certificates may be considered analogous to US Trust Certificates and can be listed and rated.").

34. Ibrahim, *supra* note 28.

35. LATHAM & WATKINS, *supra* note 17.

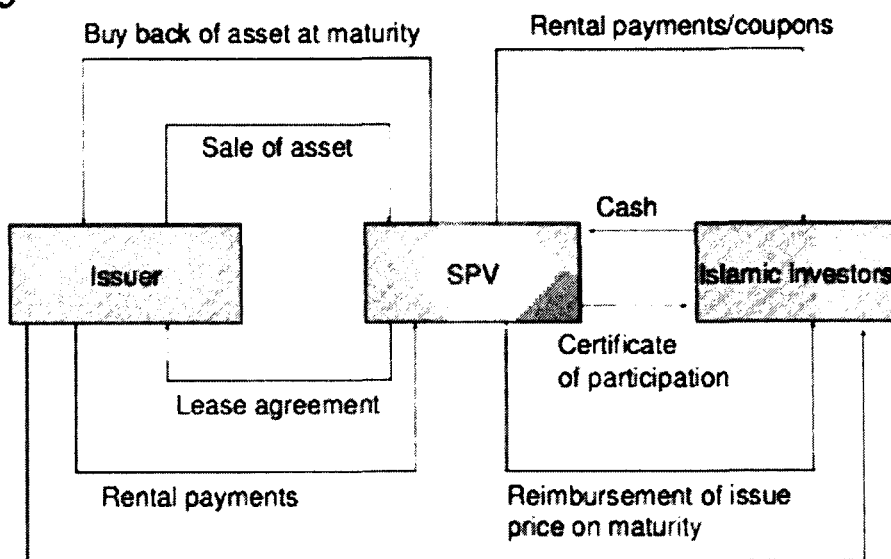
36. Rahail Ali, *An overview of the sukuk market*, in *SUKUK AND ISLAMIC CAPITAL MARKETS: A PRACTICAL GUIDE* 17 (Rahail Ali ed., 2011).

37. Andrew Henderson, *Testing the Water: The Dubai FSA Handles Its First Locally Managed Sukuk*, 26 INT'L FIN. L. REV., no. 9, 16 (Sept. 2007) ("The idea behind *sukuk* (the plural of the Arab word *sak*, meaning certificate) is simple. The prohibition on interest under [*Shari'ah* . . .] makes the creation of a [*Shari'ah*]-compliant pure debt security impossible. However, an obligation that is linked to the performance of a real asset is acceptable. The [*Shari'ah*] accepts the validity of a financial asset that derives its return from the performance of an underlying real asset or pool of assets.").



certificates) to investors in exchange for proceeds, which are then used to purchase the pool of assets (typically *Shari'ah*-compliant contracts) from the originator or original owner of the assets.<sup>38</sup> The stream of income generated from the *Shari'ah*-compliant contracts or assets is used to pay back the *sukuk*-holders.<sup>39</sup> The below graphic<sup>40</sup> illustrates an *ijara sukuk* structure whereby an issuer owning *Shari'ah*-compliant assets transfers them into a trust or similar SPV, which then sells *sukuk* (certificates of participation) to investors while leasing back the assets to the issuer at a rate sufficiently high to generate an agreeable profit for investors:

### *Ijara sukuk* structure



Most *Shari'ah* scholars agree that the pool of assets should not only be comprised of instruments only representing an interest in a stream of payments (such as *murabaha* contracts), but rather should be at least half comprised of instruments representing an interest in the underlying assets themselves (like *ijara*).<sup>41</sup> This is to say that

38. LATHAM & WATKINS, *supra* note 17.

39. *Id.*

40. Rodney Wilson, *Islamic Asset Management*, SGIA RESEARCH WORKING PAPERS SERIES (June 2007), <http://www.dur.ac.uk/resources/sgia/SGIARWP07-01.2.doc.pdf>.

41. *Id.*

*Shari'ah* favors clear ownership interest in underlying assets rather than simply the receivables arising thereunder. Thus according to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), whose standards are generally followed by issuers of *sukuk*, *sukuk* "may not be issued on a pool of receivables."<sup>42</sup>

### III. Risk Factors – Asset-Backed and Other Considerations

#### A. Recharacterization Risk

Although *sukuk* are structured to generate a fixed return based on the expected return of underlying assets (i.e., they are "asset-based"), they do not always provide creditors with recourse to the underlying assets themselves (i.e., they are not always truly "asset-backed").<sup>43</sup> *Sukuk* are often structured so that investors have economic exposure to the credit risk of a corporate or sovereign originator of assets and depend on that entity's solvency for their return.<sup>44</sup> Thus the credit ratings on such *sukuk* reflect the rating of this entity (rather than the pool of assets).<sup>45</sup> Therefore,

it is more accurate to refer to [these] *sukuk* as an asset-based investment, as each investor owns an undivided interest in an underlying tangible asset which can be structured to give a fixed-income economic return in a *Shari'ah*-compliant manner. The *sukuk* certificate evidences this ownership interest, but is not a debt or bond in the "IOU" sense. In short, moneys raised by the issue of the *sukuk* certificates are used to invest in an underlying asset, a trust or agency is declared over the asset and the investor thereby becomes an owner in a beneficial or indirect interest in that asset in proportion to its investment, and is thus entitled to all benefits that this entails, including a proportion of the return generated by that asset.<sup>46</sup>

On the other hand, conventional asset-backed securities are structured so that investors have exposure and recourse to the underlying assets rather than to the originator.<sup>47</sup>

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42. Ibrahim, *supra* note 28, at 720.

43. Mohammed & Sabeti-Rahmati, *supra* note 19.

44. *Id.*

45. *Id.*

46. Debashis Dey & Stuart Ure, *Islamic securitization*, in *SUKUK AND ISLAMIC CAPITAL MARKETS: A PRACTICAL GUIDE* 146 (Rahail Ali ed., 2011).

47. Mohammed & Sabeti-Rahmati, *supra* note 19.

The asset-based versus asset-backed distinction is only meant to reflect the different risk profiles of each creditor; while asset-based lenders/investors face borrower or counterparty credit risk, asset-backed lenders/investors only face market and related asset risk on the underlying portfolio and need not depend on the issuer's solvency.<sup>48</sup> Moreover, just because a *sukuk* is asset-backed does not mean that investors will in fact get unencumbered access to the underlying assets; the legal documentation must clearly stipulate that investors have true ownership and thus unlimited disposition rights over the assets, *sans* limitation to cash flows or liquidation restrictions.<sup>49</sup>

Hence AAOIFI standards note that *sukuk* documentation must explicitly abide by *Shari'ah* and that a *Shari'ah* board must monitor its implementation.<sup>50</sup> But "like most bonds, most *sukuk* issued today are asset-based, which grants the certificate holder rights on a portion of the cash flows. There are often no direct links to actual assets, which is a condition of [*Shari'ah*]."<sup>51</sup> Complicating matters is the fact that much *sukuk* documentation imports conventional bond default provisions,<sup>52</sup> effectively blurring the line between a *Shari'ah*-compliant risk *sharing* instrument and a conventional (Western) risk *transfer* instrument.

Thus some lawyers who practice in the Islamic financial space

48. Wilson, *supra* note 5.

49. *Sukuk it up: [Shari'ah]-compliant finance is not broken, but it is dented*, THE ECONOMIST (Apr. 17, 2010), at 82, <http://www.economist.com/node/15908503> ("Much more damaging is widespread confusion among *sukuk* investors about the sorts of risks they were really taking on. A *sukuk* is structured to avoid the Islamic prohibition on interest payments. It manages this by paying bondholders with the cashflows generated by specific assets, which are put into a special-purpose vehicle . . . as part of the deal. Many seem to have thought that the bonds were 'asset-backed[,]' giving them a claim on the assets in the event of a default. Most *sukuk*, however, are 'asset-based[,]' handing investors ownership of the cashflows but not of the assets themselves. 'Many *sukuk*-holders have a perception that they hold a security that is collateralised,' says Anouar Hassoune of Moody's, a rating agency. 'In 90% of cases, that is incorrect.'").

50. Oliver Ali Agha & Claire Grainger, *Sukuk: Default or No Default?*, AGHA & SHAMSI COMMENT (Jan. 2010), <http://www.aghashamsi.com/downloads/SukukDefaultArticle.pdf>.

51. Khnifer, *supra* note 13. See also Debashis Dey & Stuart Ure, *supra* note 46, at 147 ("the vast majority of *sukuk* to date are not 'true securitizations', meaning that investors have no claim against the assets during a default (unless there has been a pledge of an asset) – this is the commercial basis on which the investment is made.").

52. Agha & Grainger, *supra* note 50.

have gone so far as to say that, “[c]learly, *sukuk* are meant to be equity-type instruments: any references to *sukuk* as being Islamic bonds are oxymoronic and misleading to investors who may believe they have certain bond-like remedies that, ultimately, may not be enforceable in some Islamic jurisdictions.”<sup>53</sup> Sheikh Usmani’s remarks that eighty-five percent of non-*ijarah* *sukuk* issuances are not in compliance with *Shari’ah* echo this view<sup>54</sup> – and undermine the credibility of the entire industry.<sup>55</sup>

This interpretation is informed by the AAOIFI’s actions during a recent controversy surrounding the [*Shari’ah*] compliance of certain types of *sukuk*. In an influential 2007 paper, the Chairman of the AAOIFI’s *Shari’ah* Board, Sheikh Muhammad Taqi Usmani, argued that *sukuk* that guaranteed purchasers interest-free loans and repurchase agreements in cases of missed payments or default were not [*Shari’ah*]-compliant, as they effectively tied an investor’s returns to the creditworthiness of the issuer instead of the value of the underlying assets in violation of *gharar* restrictions. Later that year, Usmani made public statements that as much as [eighty-five percent] of the world’s *sukuk* could be [*Shari’ah*]-noncompliant due to these and other measures, triggering an intense controversy. After several months of debate, the AAOIFI confirmed much of Usmani’s analysis and issued new *sukuk* guidelines prohibiting these practices. Tellingly, these guidelines also admonished the [*Shari’ah*] supervisory boards that had permitted such activities, reasserting their duty to “make sure

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53. *Id.*

54. John Foster, *How Sharia-compliant is Islamic banking?*, BBC NEWS (Dec. 11, 2009), <http://news.bbc.co.uk/2/hi/business/8401421.stm> (“The question’s pertinence was raised in March last year, when Sheikh Muhammad Taqi Usmani, of the Accounting and Auditing Organization for Islamic Finance Institutions (AAOIFI), a Bahrain-based regulatory institution that sets standards for the global industry, said that 85% of Sukuk, or Islamic bonds, were un-Islamic. Usmani is the granddaddy of modern-day Islamic finance, so having him make this statement is synonymous with Adam Smith saying that free-markets are inefficient.”). See also *Dubai’s Escape from Default Escalates Sukuk Uncertainty*, ASIAMONEY, Jan. 13, 2010, <http://www.asiamoney.com/Article/2371366/Dubais-escape-from-default-escalates-sukuk-uncertainty.html>

55. But see Jack Bunker, *Not Quite Cricket: High Court Drops Islamic Finance Ball?*, WESTLAW BUSINESS CURRENTS (Mar. 10, 2010), <http://currents.westlawbusiness.com/Article.aspx?id=1a3e4075-c705-4747-8938-1d7a0b330483> (“Of critical importance is the fact that under Islamic law, no *fatwa* (decree) once duly issued by an *imam* (scholar) or board of scholars, can be reversed or overturned. A noted scholar, Sheik Taqi Usmani, famously declared that many *sukuk* structures are not *Shariah*-compliant; the statement, however, had no actual effect on these instruments - it amounted simply to dicta.”).

that the operation complies, at every stage, with [Shari'ah] guidelines and requirements." As [AAOIFI Secretary-General Mohamed] Alchaar later described, these actions effectively "wrecked the market" for *sukuk*, leading to a decrease in overall issuances and a dramatic shift toward less controversial *ijara*-based *sukuk* structures. As institutions feared that consumers would react negatively to the AAOIFI's public censure, they rallied market forces that effectively curbed the offending practices and triggered a more widespread reevaluation of *sukuk* standards by issuers.<sup>56</sup>

Therefore "[u]nless it's specifically stated in the documentation, a creditor's right is not typically to that cash-generating asset, which is there chiefly to ensure *Shari'ah* compliance, but to the obligor's balance sheet, which can be a very different proposition."<sup>57</sup> "The relationships are fairly well-defined: the obligor's obligations to *sukuk*-holders rank *pari passu* with the other unsecured creditors, but senior to equity holders."<sup>58</sup>

In the event of a default by the obligor or on maturity, the only recourse available to *sukuk*-holders is to "put" the assets (or, specifically, the beneficial interest that has been purchased) back to the obligor, which creates a payment obligation in favour of *sukuk*-holders. In this respect, *sukuk*-holders' claims on the obligor are equivalent to those of other unsecured creditors on the basis that *sukuk*-holders have no retention of title to the assets underpinning the *sukuk*.<sup>59</sup>

*Sukuk*-holders have cause for concern that a *sukuk* structure would be recharacterized as asset-based rather than asset-backed only if, of course, they expect to face litigation in a *Shari'ah*-abiding jurisdiction. This is a reasonable assumption because all *sukuk* structures involve *Shari'ah*-abiding issuers,<sup>60</sup> assets,<sup>61</sup> or investors.<sup>62</sup>

56. Scott R. Anderson, *Recent Development: Forthcoming Changes in the Shari'ah Compliance Regime for Islamic Finance*, 35 YALE J. INT'L L. 237, 241–42 (2010).

57. Khnifer, *supra* note 13.

58. Daniel Rankin, *Restructuring and buy-back of sukuk*, in *SUKUK AND ISLAMIC CAPITAL MARKETS: A PRACTICAL GUIDE* 157 (Rahail Ali ed., 2011).

59. Yavar Moini, *supra* note 11, at 35.

60. Generally the issuer is an offshore special-purpose vehicle (structured this way largely for tax purposes), in which case the documentation would likely provide for English or New York governing law. See *How to set sukuk free*, *supra* note 8. However, the largest *sukuk* default to date, which was not litigated but rather swiftly restructured, involved an issuer "incorporated in the Jabel Ali Free Zone, subjecting the sale or lease of the collateral assets to [S]hari'ah-based United

This is because *sukuk* exist to broker the demand of financiers and *Shari'ah*-abiding investors.<sup>63</sup> This demand continues to grow.<sup>64</sup> Although many contracting parties select arbitration, which is enforceable in some jurisdictions like parts of the United Arab Emirates,<sup>65</sup> or alternatively opt to restructure *sukuk* on the brink of or post-default,<sup>66</sup> a large enough *sukuk* with disparate stakeholders

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Arab Emirates (UAE) law as applied by Dubai courts.” Heiko Hesse and Andreas Jobst, *Debriefing Nakheel – Wider Implications for the Sukuk Market*, ROUBINI GLOBAL ECON. (Apr. 29, 2010), [http://www.roubini.com/financemarkets-monitor/258811/debriefing\\_nakheel\\_-\\_wider\\_implications\\_for\\_the\\_sukuk\\_market](http://www.roubini.com/financemarkets-monitor/258811/debriefing_nakheel_-_wider_implications_for_the_sukuk_market).

61. See Dominic O'Neill, *Islamic finance: Sukuk market on trial as Islamic bonds default*, EUROMONEY (July 2009), <http://www.euromoney.com/Article/2245562/BackIssue/72526/Islamic-finance-Sukuk-market-on-trial-as-Islamic-bonds-default.html> (“As most [*sukuk*] were issued by offshore special purpose vehicles governed by English law, a ruling would have to be sought in an English court. This would then need to be enforced in the Middle East, the location of most of the assets of *sukuk* issuers.”).

62. See Kristen A. Bell & Ann Saegert, *Basic Primer on [Shari'ah]-Compliant Finance*, HAYNES & BOONE LLP (Oct. 17-19, 2008), <http://www.haynesboone.com/files/Publication/1f130179-11fa-4858-96ae-248674baf629/Presentation/PublicationAttachment/171ddd61-e465-43fb-a4d5-ae74ab0cf6a3/BasicPrimeronShariaCompliantFinance.pdf> (describing the East Cameron Gas *sukuk* structure, which was a capital-raising designed to tap *Shari'ah*-abiding investors, but which otherwise involved assets and issuers in Texas) and Khnifer, *supra* note 13 (reporting that East Cameron Partners, the defaulting originator in the *sukuk*, lost out to *sukuk*-holders when the United States judge issued a decision granting *sukuk* certificate holders full and exclusive ownership and possession of the assets. “As a matter of U.S. law, the result is the treatment of the SPV assets as being the product of a true sale. This essentially meant that the SPV did in fact own the assets, and was not merely a collateral holder for secured loans.”).

63. *Introduction to Islamic Project Finance*, CLIFFORD CHANCE (Jan. 2009), [http://www.cliffordchance.com/publicationviews/publications/2009/01/introduction\\_to\\_islamicprojectfinance0.html](http://www.cliffordchance.com/publicationviews/publications/2009/01/introduction_to_islamicprojectfinance0.html).

64. Muhammad Al-Bashitr Muhammad Al-Amine, *supra* note 11 (“The size of global [*Shari'ah*-compliant] assets is estimated at about \$400 billion to \$500 billion. Institutions like Standard & Poor's Ratings Services believe that the potential market for Islamic financial services is closer to \$4 trillion, meaning that Islamic finance currently has only achieved about 10% of its potential and therefore still has a long way to go. The market share of Islamic financial institutions is estimated to stand at 12 per cent in Malaysia and 17 per cent in the six GCC countries where it is growing faster than anywhere else”).

See also Bilal Aquil & Imran Mufti, *Innovation in the Global Sukuk and Legal Structuring Considerations*, in *ISLAMIC FINANCE: A PRACTICAL GUIDE* 101 (Rahail Ali ed., 2008).

65. *Doing Business in the United Arab Emirates*, LATHAM & WATKINS LLP (Jan. 2009), [http://www.lw.com/upload/pubContent/\\_pdf/pub2783\\_1.PDF](http://www.lw.com/upload/pubContent/_pdf/pub2783_1.PDF).

66. See generally Omar Salah, *Dubai Debt Crisis: A Legal Analysis of the Nakheel Sukuk*, 4 BERKELEY J. INT'L L. PUBLICIST (2010) (very helpful analysis of the \$3.52 billion Nakheel *sukuk* issued to finance the World and Palm islands).

could conceivably end up in litigation.<sup>67</sup>

There is little clarity in such a default scenario. What is settled is that Dubai, for one, would prioritize secured creditors (although it is unclear how they would rank amongst themselves),<sup>68</sup> whereas courts in the Emirate's free zone (the International Financial Centre or "DIFC") would lump secured and unsecured creditors together after preferred creditors.<sup>69</sup> Preferred creditors are generally: pensioners; employees in the four months preceding liquidation; those owed any payments due in lieu of notice, or in respect of accrued holiday entitlement.<sup>70</sup> The DIFC is not, however, the only *Shari'ah*-abiding jurisdiction,<sup>71</sup> and there are significant inconsistencies within and among *Shari'ah*-abiding jurisdictions as to the validity and enforceability of *sukuk*<sup>72</sup> – and related judgments rendered abroad.<sup>73</sup>

67. See Robin Wigglesworth, *Fresh suits filed in Saudi dispute*, ZAWYA (Apr. 12, 2011), [http://ae.zawya.com/story.cfm/sidZAWYA20110413053754/?relcontent=20110922\\_6118\\_906](http://ae.zawya.com/story.cfm/sidZAWYA20110413053754/?relcontent=20110922_6118_906) (discussing multi-jurisdictional litigation in the Saad-Algosaibi matter).

68. Daniel Rankin, *supra* note 58, at 162-63 ("In the GCC, where the insolvency regimes are uncertain, . . . have developed unevenly and are generally untested and therefore unpredictable . . . due to the lack of precedent, there exists no definitive priority ranking of creditors and no way to determine how creditors will be paid in the event of a liquidation of the obligor's assets. There is also little guidance on the relative length of an insolvency proceeding or how it will be carried out in practice."). See also *Restructuring and Insolvency in the United Arab Emirates*, LATHAM & WATKINS LLP (Mar. 2010), [http://www.lw.com/upload/pubContent/\\_pdf/pub2881\\_1.pdf](http://www.lw.com/upload/pubContent/_pdf/pub2881_1.pdf).

69. *Restructuring and Insolvency in the Dubai International Financial Centre*, LATHAM & WATKINS LLP (Mar. 2010), [http://www.lw.com/upload/pubContent/\\_pdf/pub2880\\_1.pdf](http://www.lw.com/upload/pubContent/_pdf/pub2880_1.pdf).

70. *Id.*

71. See *Islamic Finance Market Turns to Securitization*, *supra* note 14 (highlighting the relatively more-developed Malaysian market).

72. Henderson, *supra* note 37, at 17 ("[A] [*Shari'ah*] scholar seeking to rule on the compliance with the [*Shari'ah*] would not look to the manner in which the product is classified or described from a secular or conventional, that is, non-Islamic, point of view. For the [*Shari'ah*] scholar, conventional labels or descriptions may be viewed as irrelevant: the important thing is whether, according to the [*Shari'ah*], the product in question is such that the scholar can, in good conscience, issue the appropriate *fatwa*. This, in turn, goes to a more fundamental issue in the context of the regulation of Islamic finance, generally: the [*Shari'ah*] as an internalized system of rules, that is, one that is interpreted by a local Islamic scholar whose views reflect those of the local community, makes it difficult for an outside agency, such as a financial service regulator, which relies on an externalized system of rules, that is, one fixed by the regulator in its legislative capacity, to seek to regulate the outcome of decisions made on the basis of the [*Shari'ah*].").

73. Agha & Grainger, *supra* note 50 ("When defaults in market *sukuk* structures

In light of potential hurdles at the litigation and enforceability stages, the risks associated with strict as opposed to “sham”<sup>74</sup> compliance with *Shari’ah* become significant in structuring *sukuk*. This is because the risk of recharacterization<sup>75</sup> is relatively high given unclear<sup>76</sup> bankruptcy regimes in *Shari’ah*-abiding jurisdictions. This is owed in part to the fact that *Shari’ah* law “doesn’t even contemplate a default, because you can’t default if all you’re ever giving is a profit share. If there are no profits, then you aren’t defaulting.”<sup>77</sup>

This fundamental risk of re-characterization both turns on and translates into a host of other related risk factors.<sup>78</sup> Essentially, this note’s position is that murkiness regarding ostensibly *Shari’ah*-compliant legal instruments, like *fatwa*-sanctioned *sukuk*, breeds uncertainty in other legal tribunals as to the treatment and recognition thereof.<sup>79</sup> Thus, to the extent *sukuk* are conventional bonds transformed into *Shari’ah*-compliant securities, they might be expected to stand in either legal regime. But this expectation may be unreasonable, because the ideologies undergirding each system are fundamentally different. This is why some commentators have remarked that, “referring to *sukuk* as Islamic bonds is like jamming a square peg into a round hole and then wondering why it doesn’t fit.”<sup>80</sup>

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result from contractual covenants imported from conventional bonds, such defaults would not necessarily be enforceable in a *Shari’ah* adjudication, regardless of decisions made in foreign courts.”).

74. Willem Buiter, *Islamic Finance Principles to Restore Policy Effectiveness*, FIN. TIMES (July 22, 2009), <http://blogs.ft.com/maverecon/2009/07/islamic-finance-principles-to-restore-policy-effectiveness/>.

75. See also Solomon Teague, *Awaiting Sukuk Clarity*, INT’L FIN. REV. (2010), <http://www.ifre.com/awaiting-sukuk-clarity/610385.article>.

76. *Gulf States Urged to Reform ‘Archaic’ Bankruptcy Laws*, ZAWYA (Jan. 25, 2011), <http://www.zawya.com/Story.cfm/sidZAWYA20110125033453/Gulf%20states%20urged%20to%20reform%20'archaic'%20bankruptcy%20laws%20>.

77. O’Neill, *supra* note 61.

78. See Michael J.T. McMillen, *Symposium: Islamic Business and Commercial Law: Contractual Enforceability Issues: Sukuk and Capital Markets Development*, 7 CHI. J. INT’L L. 427, 452–58 (2007) (in-depth treatment of these and other risk factors).

79. See Bunker, *supra* note 10 (reporting on the decision of the English High Court of Justice in *Investment Dar Co. KSCC v. Blom Developments Bank SAL* (Dec. 11, 2009), which effectively challenges the very structure of an instrument duly approved by a competent *Shari’ah* board - in spite of a written agreement to the contrary).

80. Agha & Grainger, *supra* note 50.



## B. Other Risks

With the risk of recharacterization in the forefront, we return to risks that *sukuk* structures will be invalidated in part or *in toto*. If the *sukuk* involves Western arrangers or investors, they are likely to structure it pursuant to principles of Western finance, which involves setting up a bankruptcy-remote special purpose vehicle (SPV), typically offshore, to house the assets.<sup>81</sup> *Sukuk*-holders' recourse to the underlying assets in this type of *sukuk* default would depend in part on the strength and content of a legal opinion from law firms' experts in local and international law as to how the law would be expected to operate in a default scenario pursuant to the stipulated choice of forum and choice of law.<sup>82</sup>

*Sukuk*-holders' recourse would also depend on whether a true sale opinion could be procured attesting to the SPV's true (as opposed to conditional or secured) ownership of the assets.<sup>83</sup> Moreover, if the issuing SPV is governed by or incorporated in a *Shari'ah* jurisdiction, these opinions might not prove foolproof. To illustrate the complex legal hurdles a *sukuk* might face, we explore the recent first non-payment of an Islamic bond in the Middle East: the \$100 million *sukuk* issued by Kuwaiti firm The Investment Dar (TID) in 2005.<sup>84</sup>

## IV. Case Study: TID

On May 12, 2009, Kuwaiti firm The Investment Dar became the first Gulf Cooperation Council-based (GCC) *sukuk* issuer to default.<sup>85</sup> The Aston Martin part owner<sup>86</sup> is not only the first Persian Gulf company to default on Islamic bonds, but its *sukuk* structures are somewhat typical in that transaction documents are "governed by English law and subject to the jurisdiction of the English

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81. Rustum Shah, *Islamic Syndications: Legal and Structuring Considerations*, in *ISLAMIC FINANCE: A PRACTICAL GUIDE* 55–65.

82. Khnifer, *supra* note 13.

83. *Id.*

84. O'Neill, *supra* note 61.

85. Blake Goud, *The TID Sukuk Default*, *BUSINESS ISLAMICA* (July 26, 2009), <http://www.islamica-me.com/article.asp?cntnt=351>.

86. Haris Anwar & Michael Patterson, *Aston Martin Owner Is First to Default on Gulf Sukuk*, *BLOOMBERG* (May 12, 2009), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aiqILW051D9c>.

Courts,"<sup>87</sup> as is the case with the majority of GCC *sukuk*.<sup>88</sup> This permits some extrapolation.

Reviewing TID's Global *Sukuk* I Offering Memorandum<sup>89</sup> reveals no relevant ambiguities: the first risk factor clearly states that if there is a default, investors have no direct recourse to the underlying assets and have to rely on the obligor (TID) to repurchase the *sukuk*.<sup>90</sup> This TID *sukuk*, like most, provides investors with limited recourse to the underlying assets insofar as they are beneficial owners but they cannot directly dispose of the underlying assets should TID default.<sup>91</sup> What this means is that while *sukuk*-holders in this case can in fact sell the assets in a default scenario, they cannot do so directly but must go through TID by exercising a repurchase or put option. Effectively then, they risk lining up with other TID creditors in the default scenario. In fact, the Offering Circular says as much:

TID represents and warrants, among other things, that its payment obligations . . . are and will be direct and unconditional, ranking at least *pari passu* with all its other *unsecured and unsubordinated debts* other than those mandatorily preferred by law.<sup>92</sup>

Presumably this is why *sukuk*-holders passed a resolution on June 7, 2010, stating that, "the Certificateholders would in due

87. See TID Global Sukuk I Limited Offering Circular, NASDAQ DUBAI 9 (2008), [http://www.nasdaqdubai.com/resources/2008/5/5/c4feeea4-b1da-4201-bb32c0ba441dc92e/Executioncopy\\_TIDOC&Financials.pdf](http://www.nasdaqdubai.com/resources/2008/5/5/c4feeea4-b1da-4201-bb32c0ba441dc92e/Executioncopy_TIDOC&Financials.pdf). Although this is a different offering circular for a different *sukuk* issuance, it is likely representative of TID's offering documentation, especially with respect to choice of forum and choice of law elections. See O'Neill, *supra* note 61.

88. Yavar Moini, *supra* note 11, at 42 ("The purchase undertaking is usually governed by English law on account of its creditor friendliness"); Rahail Ali and Imran Mufti, *Legal and structural anatomy of a sukuk*, in *SUKUK AND ISLAMIC CAPITAL MARKETS: A PRACTICAL GUIDE* 53 (Rahail Ali ed., 2011) ("The governing law for the declaration of trust is usually English law"); Mazen Boustany & Muhammad Syamsulfaiz Zainuddin, *What went wrong? Credit crisis and Islamic finance*, THE IN-HOUSE LAWYER (June 10, 2010), <http://www.inhouselawyer.co.uk/index.php/united-arab-emirates/8069-what-went-wrong-credit-crisis-and-islamic-finance>.

89. Again, this Offering Memorandum (OM) is for a distinct \$150 million offering from 2006 that listed on the Dubai Exchange, whereas Part III opens by discussing the TID default on its earlier \$100 million 2005 offering that listed exclusively on the Kuwaiti Exchange and for which the OM could not be located.

90. TID Global Sukuk I Limited Offering Circular, *supra* note 87, at 11.

91. *The TID Sukuk Default*, *supra* note 85.

92. TID Global Sukuk I Limited Offering Circular, *supra* note 87, at 4.

course like to further consider the potential of asserting priority claims in respect of the *Sukuk* Assets.”<sup>93</sup> The legal effect of such an *ex post facto* resolution is unclear.

Complicating matters is the fact that the assets, vehicles to be purchased from TID and leased pursuant to a *musharaka* (joint venture) agreement, appear to be in Kuwait.<sup>94</sup> This is to say that even a favorable judgment for *sukuk*-holders in an English court might be compromised at the enforceability stage, since Kuwait does not appear to have reciprocal agreements with England to honor each other's court judgments.<sup>95</sup> This is all to say that in the case of TID, “it appears that although the investors . . . invested in an asset-based *sukuk*, they are essentially unsecured creditors. The Offering Circular provides them with a return of principal upon default, but it does not provide them with recourse to the underlying assets.”<sup>96</sup>

Notwithstanding ultimate enforceability hurdles, an interesting development in the TID default might shed light on English treatment of the transaction. *Sukuk*-holders (now restructuring),<sup>97</sup> unsurprisingly are not the only casualties in TID's bankruptcy. TID had a separate *wakala* (agency-like) arrangement with Lebanese-incorporated Blom Bank,<sup>98</sup> which provided that TID would invest Blom deposits in a *Shari'ah*-compliant manner.<sup>99</sup> The arrangement

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93. *The TID Sukuk Default*, *supra* note 85.

94. *TID Global Sukuk I Limited Offering Circular*, *supra* note 87, at 47. See also TID's Interim Condensed Financial statements attached to the executed Offering Memorandum, indicating that TID and its subsidiaries are incorporated in Kuwait. *Id.*

95. Kuwait Office, *Kuwait: Enforcing Foreign Judgments and Arbitral Awards in Kuwait*, AL TAMIMI & CO. (Apr. 7, 2010), available at <http://www.mondaq.com/article.asp?articleid=97072> (“While the law permits courts in Kuwait to issue an order for the execution of judgments rendered in a foreign jurisdiction under limited circumstances, the Kuwaiti courts are generally not in the practice of enforcing foreign judgments.”).

96. *The TID Sukuk Default*, *supra* note 85.

97. *TID Global Sukuk I Limited Restructuring Update*, ZAWYA (Feb. 21, 2011), <http://www.zawya.com/story.cfm/sidZAWYA20110222070635/TID%20Global%20Sukuk%20I%20Limited%20-%20Restructuring%20Update>.

98. Michael Godden & Neil D. Miller, *The implications for the Islamic finance market of the Investment Dar Company KSCC v Blom Developments Bank SAL*, (Mar. 16, 2010), available at <http://www.lexology.com/library/detail.aspx?g=4e91259a-6111-442e-b397-d69e41e68115>.

99. *Id.*

was similarly governed by English law.<sup>100</sup> At the end of the investment period, TID was obligated to repay the capital together with an agreed anticipated return, regardless of whether or not the capital sum generated a profit for TID.<sup>101</sup>

TID failed to fulfill its payment obligations under the arrangement and Blom sought, and was granted, summary judgment in the amount of the capital sum but not on the agreed anticipated return.<sup>102</sup> TID appealed the summary judgment arguing that the arrangement was *ultra vires* (thus invalid) since TID was in fact accepting interest-bearing deposits as prohibited by *Shari'ah* and by TID's bylaws – notwithstanding the fact that the transaction had been approved by a *Shari'ah* advisory board!<sup>103</sup>

The High Court of Justice Chancery Division allowed the appeal,<sup>104</sup> “effectively invalidat[ing] an industry estimated to be worth approximately \$1[TR].”<sup>105</sup> “By maintaining that if “at least to some eyes,” Islamic finance appears to bring about “the payment of interest under another guise,” the court effectively gives the world at large plenary power to veto any Islamic [*Shari'ah*] board.”<sup>106</sup> *Sukuk*-holders thus seem to face the additional risk that their investment structure will be deemed invalid, even in a Western court and notwithstanding English choice of law provisions – all owing to *Shari'ah* transactional elements or requirements that may further complicate the structure.

In sum, true recourse to assets in a *sukuk* is crucial in a default scenario for *sukuk*-holders,<sup>107</sup> and arguably with respect to most *Shari'ah*-compliant financial instruments – in part because it falls out of the fundamental *Shari'ah* prohibitions on interest-bearing debt and uncertainty. Of course asset-based or unsecured *sukuk* exist –

100. *Wakala contracts: what are the implications of the judgment in TID v Blom?*, ALLEN & OVERY (Mar. 5, 2010), <http://www.allenovery.com/AOWEB/AreasOfExpertise/Editorial.aspx?contentTypeID=1&itemID=55078&prefLangID=410>.

101. *Id.*

102. *Id.*

103. *Id.*

104. *Investment Dar Co KSCC v Blom Developments Bank Sal* [2009] EWHC 3545 (Ch).

105. Bunker, *supra* note 55.

106. *Id.*

107. The AAOIFI's 2008 pronouncement on the matter squares with Sheikh Usmani's statements that the majority of *sukuk* are not in compliance with *Shari'ah*. See Scott R. Anderson, *supra* note 56.

they are just not in strict compliance with *Shari'ah*<sup>108</sup> and so carry recharacterization risk, which means creditors will likely have to share the pie with creditors of the defaulting debtor.

## V. A Look Into The Future: Restructuring on the Horizon

### A. Nakheel's Restructuring

While the initial TID *sukuk* default was unlikely to move markets given its relatively small notional value (\$100 million), more issuances are in the pipeline. "Despite the crisis, the [*Shari'ah*]-compliant banking industry has been expanding. In a situation of stress it has still grown by 20% – and just imagine how much more it will grow once the situation stabilises and liquidity returns," says Anouar Hassoune, Moody's vice-president of Middle East banking.<sup>109</sup> In the face of continued legal ambiguity, many similarly positioned cash-strapped entities are restructuring their debts, as TID moved to do on more than eighty percent of its debts valued at \$3.8 billion, including the \$100 million *sukuk* debt.<sup>110</sup>

Thus taking a bird's eye view reveals that most near or in default are restructuring their debts rather than risking high-stakes legal refuge in a *Shari'ah*-abiding jurisdiction.<sup>111</sup> The most significant such restructuring was of Dubai-incorporated Nakheel Development Limited's ("Nakheel") \$3.52 billion debt.

In December 2006, Nakheel issued the largest *sukuk* to date, designed to capitalize Nakheel PJSC, the company responsible for landmark developments such as The Palm, Jumeirah, and The

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108. Unfortunately *fatwas*, if public, do not always disclose scholars' reasoning as to how unsecured *sukuk* pass *Shari'ah* muster. See CIMB ISLAMIC SHARI'AH COMM., *Cherating Capital Limited Shariah Endorsement*, available at [http://www.bursa malaysia.com/website/bm/market\\_information/listed\\_bonds/downloads/Cherating\\_Capital\\_Ltd\\_Shariah\\_Endorsement.pdf](http://www.bursa malaysia.com/website/bm/market_information/listed_bonds/downloads/Cherating_Capital_Ltd_Shariah_Endorsement.pdf) (endorsing an issuance notwithstanding explicit recourse to the obligor rather than the issuer).

109. James Gavin, *Gulf Islamic banks gear up for change*, THE BANKER (Feb. 2010), <http://www.thebanker.com/World/Middle-East/Gulf-Islamic-banks-gear-up-for-a-change?ct=true>).

110. Robin Wigglesworth, *TID restructuring talks break down*, FIN. TIMES (Nov. 29, 2010), <http://www.ft.com/cms/s/0/42537f82-fb09-11df-b576-00144feab49a,s01=1.html#axzz1FC4f5Fmr>.

111. See *Defaults in Islamic Finance: A [Shari'ah] Perspective: Timeline of Key Events*, DAR AL ISTITHMAR 2 (Dec. 1, 2009), <http://www.daralistithmar.com/files/Defaults%20in%20Islamic%20Finance%20-%20A%20Shari'a%20perspective.pdf>.

World.<sup>112</sup> While Nakheel is a subsidiary of Dubai World, a holding company that manages and supervises a portfolio of businesses and projects for the Government of Dubai,<sup>113</sup> the Dubai government has no legal obligation to repay the debts of government-related entities, including Nakheel and its parent Dubai World.<sup>114</sup> Complicating matters is the fact that the underlying assets (land) are in Dubai but arguably owned by the sovereign and thus subject to sovereign immunity<sup>115</sup> in attachment.<sup>116</sup> Fortunately for creditors however (though unfortunately for the sake of developing legal precedent), neighboring Emirate Abu Dhabi intervened with a \$10 billion loan, a portion of which was used to prevent a Nakheel *sukuk* default.<sup>117</sup>

Creditor recourse to restructuring makes sense given the lack of legal clarity in the Gulf around defaults.<sup>118</sup> Should this lack of clarity persist, some predict a future of Islamic finance in name only, yet structured in conformity with Western financial principles.<sup>119</sup>

In sum, we know that Islamic finance is here to stay<sup>120</sup> and

112. *Largest Sukuk Ever*, INT'L FIN. L. REV. (Jan. 2007), <http://www.iflr.com/Article/1977366/Largest-sukuk-ever.html?Print=true>.

113. *Id.*

114. *Sovereign Sukuk Reigns Supreme*, ISLAMIC FIN. ASIA (Apr. 2010), [http://www.islamicfinanceasia.com/article.asp?nm\\_id=18745](http://www.islamicfinanceasia.com/article.asp?nm_id=18745).

115. One fascinating area of legal ambiguity is sovereign debt restructuring, which presents even more hurdles and in respect of which Professor Schwarcz makes a very compelling case for a supranational solution. See Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 956 (2000).

116. See Salah, *supra* note 66 for an excellent discussion of the Nakheel *sukuk* structure and Dubai-specific legal hurdles.

117. Brian Baxter, *Ashurst, Clifford Chance, Latham Leading on Latest Dubai Debt Restructuring*, THE AMERICAN LAWYER (Mar. 25, 2010), available at <http://www.law.com/jsp/law/international/LawArticleIntl.jsp?id=1202446902819&slreturn=1>.

118. See *Dubai's Escape from Default Escalates Sukuk Uncertainty*, *supra* note 54, at 114 ("But if a *sukuk* goes wrong, it's not clear what rights creditors have to the underlying assets . . . . The majority of *sukuk* are unsecured paper, and there is no expectation whatsoever on the part of the creditors for using the underlying asset to get back their money . . . . That asset is just there in a transaction to make it *Shariah*-compliant. It is never intended to be collateral . . . . One of the major things that is missing in the Gulf is the bankruptcy law.").

119. See generally McKean James Evans, Note, *The Future of Conflict Between Islamic and Western Financial Systems: Profit, Principle and Pragmatism*, 71 U. PITT. L. REV. 819 (2010).

120. See Heather Timmons, *Dubai Crisis Tests Laws of Islamic Financing*, N.Y. TIMES (Nov. 30 2009), <http://www.nytimes.com/2009/12/01/business/global/01islamic.html> ("The surge in Islamic finance has led to hiring sprees at banks, and given rise to a series of new financial indicators like the Dow Jones Islamic Market index. Hoping to appeal to the Middle East's huge sovereign wealth funds, even

swiftly growing,<sup>121</sup> but suffers from fundamental structural impediments that preclude legal certainty in and among *Shari'ah*-abiding jurisdictions. The latter characteristic is owing to the fact that *muftis* (Islamic law scholars) on *Shari'ah* advisory boards may disagree on transactional compliance much in the same way as ratings agencies in conventional finance.<sup>122</sup> Furthermore, the existence of at least four main schools of Islamic thought<sup>123</sup> enhances legal variance across jurisdictions, compounding or at least further complicating the scholar-shopping phenomenon.<sup>124</sup>

### *B. In the Wake of Nakheel*

So what are the broader global implications? To facilitate speculation, we return to the sovereign wealth fund default hypothetical introduced *supra*.<sup>125</sup> As it turns out, this scenario is not so far-fetched. For one, even if Nakheel's debts had been fully guaranteed by the Dubai Government, would that have helped had Abu Dhabi not stepped in? No. Moreover, we know that sovereigns do in fact default.<sup>126</sup> Even more to the point, we know

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non-Islamic institutions have started to raise money using Islamic finance.”).

121. See Stuart Flynn, *An Islamic Capitalism*, INT'L FIN. L. REV. (July 2008), <http://www.iflr.com/Article/1976391/An-Islamic-capitalism.html>.

122. But see David Segal, *Suddenly, the Rating Agencies Don't Look Untouchable*, N.Y. TIMES (May 22, 2010), <http://www.nytimes.com/2010/05/23/business/23rating.html?pagewanted=1&r=1> (reporting on consumer litigation against the three main rating agencies, which all but have a government-sanctioned monopoly on blessing financial transaction structures – and which all effectively awarded Lehman Brothers unsecured debt instruments ratings reflecting risk-free investments).

123. *Islamic Finance Market Turns to Securitization*, *supra* note 14.

124. *Id.* (discussing variance across the more developed Malaysian *sukuk* market vis-à-vis the less homogeneous Middle Eastern *sukuk* market). See also Foster, *supra* note 54 (“We create the same type of products that we do for the conventional markets. We then phone up a Sharia scholar for a Fatwa [seal of approval, confirming the product is Shari'ah compliant]. ‘If he doesn't give it to us, we phone up another scholar, offer him a sum of money for his services and ask him for a Fatwa. We do this until we get Sharia compliance. Then we are free to distribute the product as Islamic.”); ‘Rock star’ scholars a risk for Islamic finance, THE MALAYSIAN INSIDER (Mar. 2, 2012), <http://www.themalaysianinsider.com/business/article/rock-star-scholars-a-risk-for-islamic-finance/>.

125. See *supra* Introduction.

126. *Argentina's debt restructuring: A victory by default?*, THE ECONOMIST (Mar. 3, 2005), <http://www.economist.com/node/3715779> (“Indeed, capital markets appear to have a remarkably short memory. Argentina has defaulted on its foreign debts five times in the past 175 years; Brazil seven times; and Venezuela nine times. A debtor can default no more than once, unless a creditor is willing to forgive and

that their wealth funds also default.<sup>127</sup> Indeed this seems somewhat perverse or ironic since sovereign wealth funds both serve as a sort of domestic/local<sup>128</sup> and global<sup>129</sup> economic stopgap in times of crisis. On the other hand, this is completely consistent with sovereign wealth funds' objectives to identify investments in both bear and bull markets. We know however, that sovereign wealth funds are swiftly returning to market.<sup>130</sup> It is therefore prudent to think through the implications of a default scenario.

One important implication is global – what could the lack of legal clarity mean for socioeconomic stability? Irrespective of whether future *sukuk* structures are issued in true compliance with *Shari'ah* or in name only, the continued lack of clarity on the horizon as to how to treat the instruments suggests most creditors will continue taking matters into their own hands by privately restructuring. Is this a bad thing? Not necessarily.

However, private restructuring of debt that affects the public welfare may not square with underlying principles of *Shari'ah*. Sovereign debt restructuring clearly falls into this category, but capital raising by quasi-sovereign entities like Nakheel and even private entities like TID still affects public welfare; their activities affect the housing and auto sectors in Dubai and Kuwait respectively. At the very bottom, their capital raising activities translate into more or less homes and cars for their constituents (or consumers).

Islam's prohibition on *riba* is unambiguous and categorically stated in the *Qur'an*: "Those who devour *riba* (interest) will not

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forget. Amnesia sometimes sets in remarkably quickly. The bad loans that Argentina inherited from the debt crisis of the 1980s were written down in 1992. Just three years later, Argentina was carrying more foreign debt, both in absolute terms and relative to the size of its GDP, than it had in 1991.").

127. Ron Fraser, *From Sovereign Wealth to Sovereign Debt*, THE TRUMPET (Feb. 25, 2010), <http://www.thetrumpet.com/?q=7011.5538.0.0>.

128. Grace Wyler, *Illinois Looks To Sovereign Wealth Funds To Help Pay Off Pension Debt*, BUSINESS INSIDER (Feb. 11, 2011), <http://www.businessinsider.com/illinois-looks-sovereign-wealth-funds-to-help-pay-off-pension-debt-2011-2>.

129. Josiane Kremer, *Norway Buys Greek Debt as Sovereign Wealth Fund Sees No Default*, BLOOMBERG (Sep. 9, 2010), <http://www.bloomberg.com/news/2010-09-08/norway-buys-greek-debt-as-sovereign-wealth-manager-anticipates-no-default.html>.

130. Giles Turner, *Sovereign wealth funds take an active approach*, E-FIN. NEWS (Jan. 25, 2011), <http://www.efinancialnews.com/story/2011-01-25/sovereign-wealth-funds-keep-it-active>.



stand except as stands one whom the devil hath driven to madness by (his) touch.”<sup>131</sup> According to Sheikh Usmani, the divine injunctions against *riba*, *gharar* and *haram* activities “combined together have a cumulative effect of maintaining balance, distributive justice and equality of opportunities.”<sup>132</sup> It is reasonable to consider the wider impact of privately negotiated debt restructurings, insofar as the public for whom much of the capital was raised might very well lack a seat at the negotiation table. This might not serve the public welfare, and risks professionalizing the Islamic financial space to the detriment of the retail investor. This might in turn translate into socioeconomic inequality and unrest. Although some argue that Islamic finance is customer driven,<sup>133</sup> will it stay this way?

## VI. Conclusion

Some argue that the uncertainty around *sukuk* default comes not from the transactional structure but from, at least in the case of Nakheel, Dubai’s legal system.<sup>134</sup> This note posits that an additional important consideration is whether the *sukuk* complies with *Shari’ah* such that it provides for clear recourse to assets rather than to the obligor. This means that the *sukuk* structure must provide for true profit sharing, which proscribes interest in the conventional sense (predetermined rate of return) and prescribes instead a return tied to the underlying commercial activity for which the financing is provided.<sup>135</sup> Thus to mitigate risk, *sukuk* documentation should reflect clear ownership interest in the underlying assets rather than

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131. See *Islamic Finance Market Turns to Securitization*, *supra* note 14 (quoting from the *Qur’an*).

132. Usmani, *supra* note 16, at xiv.

133. Gavin, *supra* note 109 (“Islamic finance is customer driven. It is not something pushed by banks or regulators or by the edict of a king. And consumer behaviour has essentially changed the behaviour of the corporate world,” says Mr Fakih.”).

134. See Salah, *supra* note 66, at 19 (“However, contrary to most expectations, the main legal issues had nothing to do with the Islamic financial structure underlying the Nakheel *Sukuk*; the issues were more inherent to the legal system of the United Arab Emirates (UAE).”).

135. Mohamed & Sabeti-Rahmati, *supra* note 19. See also *Understanding Islamic Finance*, ALLEN & OVERY LLP (May 23, 2008), <http://www.allenoverly.com/AOWEB/Knowledge/Editorial.aspx?contentTypeID=1&itemID=34362&prefLangID=410>.

simply the receivables arising thereunder.<sup>136</sup> Legal characterization of a *sukuk* as asset-backed or asset-based impacts *sukuk*-holders' rights in a default scenario should litigation involve a *Shari'ah* tribunal. While this depends on a robust legal regime for enforceability, among other considerations, parties' intent to enter into a *Shari'ah*-compliant *sukuk* ought to be clearly articulated in relevant documentation. If anything is certain in the legal world of Islamic finance, it is that financial instruments must be tied to underlying assets,<sup>137</sup> because money is merely "a medium of exchange"<sup>138</sup> and "*sukuk* are, above all, ethically driven."<sup>139</sup> The further *sukuk* structures veer from this principle, the less likely they are to be approved by *Shari'ah*-governed tribunals – in part or in whole. Notably, this structuring strategy disadvantages issuers who do not have assets with which to collateralize a *sukuk*. Although this has been recently addressed by substitution of the underlying asset during the life of the *sukuk*,<sup>140</sup> difficulties remain in the unsecured debt space.

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136. Debashis Dey & Stuart Ure *supra* note 46, at 148 ("In order for the instruments ultimately evidencing an investment in an asset-backed transaction to achieve the appropriate credit rating, the transfer or sale of assets must be a sale which would survive the insolvency of the original obligor (*i.e.*, the assets must be isolated from the bankruptcy estate of the obligor). This is achievable only to the extent that the transfer represents a true transfer of ownership which is legally perfected."); *id.* at 154 ("In order for existing *sukuk* transactions to embrace fully the concept of risk following transfer of asset ownership, the structures require, among other things, a true of perfected sale of assets by the owner of such assets and for the investors to take true economic risk on performance of the assets themselves.").

137. *Id.*

138. Ibrahim, *supra* note 28, at 661.

139. Rahail Ali, *supra* note 36, at 20.

140. See Al-Amine *supra* note 11, at 7–11 (discussing DAAR *sukuk* I & II structures).

## VII. Glossary<sup>141</sup>

*Dirham*: A unit of currency in several Arab nations, and formerly the related unit of mass (the Ottoman dram) in the Ottoman Empire and Persian states.

*Fatwa*: A non-binding legal verdict or pronouncement based on *fiqh*, given by a *Shari'ah* scholar or *Shari'ah* board.

*Fiqh*: Islamic jurisprudence.

*Gharar*: Uncertainty, chance or risk; ambiguity and uncertainty in transactions.

*Hadith*: Sayings and practices of the Prophet Mohammed (peace be upon him).

*Haram*: An act or product that is unlawful or prohibited in Islam.

*Ijara*: A lease – literally means “to give something on rent.”

*Istisna'a*: Sale of an asset to be produced.

*Mudaraba*: Akin to a silent partnership or investment trust management, with the *rub ul-maal* providing capital of the *mudaraba* and the *mudarib* using its skill and enterprise in investing that capital.

*Mudarib*: The person who provides entrepreneurship and management of a *mudaraba*. *Rub al-maal* are the investors or providers of capital of the *mudaraba*.

*Mufti*: One who issues *fatwas*.

*Murabaha*: Sale at cost plus agreed and stated profit.

*Musharaka*: Partnership or joint venture.

*Riba*: Interest or usury.

*Rub al-maal*: A person who invests in *mudaraba*.

*Shari'ah*: (literally, the way to the fountain) The principle from the Koran and *Sunnah* to guide Muslims in the good conduct of their lives and for the good of the community as a whole.

*Sakk* (pl. *Sukuk*): In contemporary Islamic finance, a trust certificate of entitlement deriving from a pro-rata undivided ownership of one or more assets. Loosely termed an “Islamic bond.”

*Sunnah*: The practices and sayings of the Prophet Mohammed

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141. RAHAIL ALI, *Glossary, in ISLAMIC FINANCE: A PRACTICAL GUIDE* 167–69.

(peace be upon him), as documented in *Hadith*.

*Wakala*: Agency.

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